SEC Adopts Final Rules on Conflict Minerals Reporting

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The Securities and Exchange Commission (SEC) issued final conflict minerals reporting rules on August 22, 2012. These rules have significant implications for public companies across many industries and are likely to result in substantial compliance costs. This advisory summarizes the final rules and suggests actions that reporting companies should take to ensure timely compliance.

On August 22, 2012, the SEC released final rules for disclosure and reporting regarding the use of conflict minerals from the Democratic Republic of Congo and adjoining countries, which we refer to collectively as DRC, as mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act. The rules are intended to prompt reporting companies to examine supply chains for conflict minerals and limit use of conflict minerals originating from the DRC.

What are Conflict Minerals?

Conflict minerals include the following and their derivatives:

- gold,
- cassiterite (metal ore from which tin is extracted),
- wolframite (metal ore from which tungsten is extracted),
- columbite-tantalite (metal ore from which tantalum is extracted), and
- any other mineral or its derivatives determined by the Secretary of State to be financing conflicts in the DRC.

Conflict minerals are used in a wide range of products such as mobile phones, computers, digital cameras, video game consoles, jewelry, light bulbs, pipes, electronic circuits and automobiles.

When will a company be required to begin compliance with the rules?

Public companies are required to file a Form SD (Specialized Disclosure) on or before May 31, 2014 covering the calendar year beginning January 1, 2013. Annual filings are required thereafter. All determinations must be made on a calendar year basis. It is important to note that the Forms SD and required exhibits are *filed* with the SEC as opposed to being *furnished*.

Who is affected by the rules?

Every issuer that is subject to reporting requirements under the Securities Exchange Act of 1934 (whether domestic or foreign) must determine if it is required to comply with the rules by answering the following questions:

1. Does the company manufacture or contract to manufacture products?

The rules apply to reporting companies who manufacture or "contract to manufacture" products, except companies that mine conflict minerals or contract to mine conflict minerals. The SEC has clarified that whether a company will be considered to "contract to manufacture" a product will depend on the degree of influence it exercises over the materials, parts, ingredients or components to be included in any product that contains any conflict mineral or its derivative.

According to SEC guidance, the following actions would *not* be considered "contracting to manufacture":

- the company specifies or negotiates contractual terms with a manufacturer that do not directly relate to manufacturing of the product (unless it results in any influence over manufacturing);
- the company affixes its brand, mark, logo or label to a generic product manufactured by a third party; or
- the company services, maintains or repairs a product manufactured by a third party.

2. Are any conflict minerals necessary to the functionality or production of a product manufactured or "contracted to be manufactured" by the company?

In determining whether a conflict mineral is "necessary to the functionality" of a product, a company will have to consider:

- whether the conflict mineral is intentionally added to the product or any of its components;
- whether the conflict mineral is necessary to the product's generally expected function, use or purpose; and
- if a conflict mineral is incorporated into a product for ornamentation, decoration or embellishment, whether the primary purpose of the product is ornamentation or decoration.

In determining whether a conflict mineral is "necessary to the production" of a product, a company will have to consider:

- whether the conflict mineral is intentionally included in the production process (other than as a tool or equipment to produce the product);

- whether the conflict mineral is included in the product; and
- whether the conflict mineral is necessary to produce the product.

Reporting companies have to comply with the rules only if the answer to both questions 1 and 2 above is yes. There is no exception based on the size of a reporting company; emerging growth companies as well as smaller reporting companies must comply.

The SEC has stated that there is no *de minimis* exception in the rules, so any use of conflict minerals in any product would require an examination of whether a company is required to comply with the rules. However, if the conflict minerals are outside of the supply chain prior to January 31, 2013, then the rules do not apply.

What are the obligations of a reporting company under the rules?

The extent of compliance by a company will depend on whether it uses conflict minerals or not, and if so, whether the minerals originate in the DRC or not. For ease of explanation, we have classified companies into the following categories:

Companies that do not use conflict minerals:

No action or disclosure is required under the rules for companies in this category. However, such companies may consider adding risk factor disclosure to their SEC reports if there is any possibility of offering new products which may use conflict minerals or if they may use conflict minerals in the future in any of their existing products.

Companies for which conflict minerals are necessary to the functionality or production of one of their products:

A company in this category is required to make a reasonable inquiry to determine the country of origin of the conflict minerals used in its products.

If the company concludes that it "*knows*" that the conflict minerals did not originate in the DRC or has "*no reason to believe"* that the minerals may have originated in the DRC, then the company must:

- file a Form SD with the SEC, which must include a brief description of the process the company undertook in making its determination and the results of such inquiry; and
- make the Form SD available on its website and provide the internet address of that site in the Form SD.

On September 5, 2012, the SEC released a draft Form SD taxonomy for public comment and indicated that comments are due by October 31, 2012. Upon completion of the public comment period and consideration of the feedback, the taxonomy will be finalized and made available for use.

Companies that know or have reason to believe that they use conflict minerals that originated in the DRC or companies that were unable to affirmatively determine that the conflicts minerals did not originate in the DRC:

A company in this category is required to conduct substantial due diligence on the source and chain of custody for the conflict minerals. The company will also be required to file Form SD and a Conflict Minerals Report as an exhibit to the Form SD (and make the same available on its website), which must include:

- a description of the due diligence process used by the company to determine the source and chain of custody of the conflict minerals;
- a certified independent private sector audit of the Conflict Minerals Report in accordance with certain prescribed standards;
- a description of whether its products are "DRC Conflict Free", "Not DRC Conflict Free" or "DRC Conflict Undeterminable". The latter determination is only available on a temporary basis of four years for smaller reporting companies and two years for all other reporting companies; and
- for products that are "Not DRC Conflict Free", the company must identify the facilities used to process the conflict minerals, the country of origin of the minerals and their efforts to determine the mine or location of origin with as much specificity as possible.

Products would be deemed to be "DRC Conflict Undeterminable" if the company is unable to determine whether the minerals originated from the covered countries, or whether they financed or benefited armed groups in the DRC or certain adjoining countries. Disclosures for products which are "DRC Conflict Undeterminable" are the same as the disclosures for products determined "Not DRC Conflict Free", and after the grace period referenced above lapses, then such products will be presumed to be "Not DRC Conflict Free".

Companies that use conflict minerals only from recycled and scrap sources:

Companies who "know" or "reasonably believe" that conflict minerals they use come from scrap or recycled sources are required to file a Form SD, disclose that the conflict minerals were obtained from recycled or scrap sources, and describe the diligence measures the company took to determine that the conflict minerals came from recycled or scrap sources.

What should companies do now to prepare for compliance with the rules?

Reporting companies must examine procedures and put policies in place immediately to ensure effective and timely compliance with rules. The rules are complex; it will take time to conduct the diligence necessary to comply with the new rules. We recommend that companies begin the process as soon as possible. Below are some suggested actions:

Product Analysis:

Companies should immediately take steps to determine whether conflict minerals are contained in their products, and whether their use is necessary to the functionality or production of such products. A company may also want to determine if any alternative minerals are available for use in the products, and the practicality of switching to other mineral alternatives in order to avoid the additional compliance obligations for use of conflict minerals. If a company knows or believes it may need to obtain a Conflict

Mineral Report, it should begin to identify potential qualified firms, pricing, and documentation required by an auditor in order to perform an audit.

Supply Chain Analysis and Review of Contracts

Companies that are likely to be subject to the rules should consider what steps they can take to determine the country of origin of the conflict minerals. As supply chain due diligence will be critical, companies should start establishing a system of controls and transparency over the supply chain.

Companies should inquire about the country of origin of the conflict minerals from their suppliers and manufacturers, understand how this information is determined and documented, and determine whether these parties can conduct effective due diligence on the sources of conflict minerals. If possible, companies should obtain compliance certifications from these third parties. Companies may also adopt either the OECD Model Supply Chain Policy or write their own 'No Conflict Minerals Use Policy', and require suppliers to certify to adherence to the policy.

In addition, companies may consider amending their supplier and manufacturing contracts to include adequate representations and warranties, covenants and indemnification provisions in light of the new rules.

Disclosures in SEC filings

If they have not already done so, companies should add risk factor disclosure in their SEC filings addressing the risks, implications and costs of complying with the rules.

If you have any questions about the content of this advisory, please contact the Pillsbury attorney with whom you regularly work, or the authors below.

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